

# Proposed EU Directive on Alternative Investment Fund Managers

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# Proposed EU Directive on Alternative Investment Fund Managers

On 30 April the European Union published a draft directive on Alternative Investment Fund Managers (AIFM). As it stands, the directive will catch managers of hedge funds, private equity funds, commodity funds and other types of institutional funds, but also, real estate funds, REITs, listed investment trusts and other forms of collective investment vehicle that have previously been outside the scope of financial services regulation.

This may come as a surprise to many in the real estate industry, as most of the debate on international fund regulation has focused on hedge funds and private equity funds.



The directive could radically reshape the alternative asset management industry in some EU countries, potentially requiring changes to managers' business models and significantly increasing the regulatory burdens on the funds themselves. The directive also poses serious questions on the accessibility of the EU's markets to non-EU alternative

fund managers and how EU-based managers with funds or connections outside the EU are going to be able to continue to operate. As the directive is largely non-sector specific, real estate funds will be subject to the same requirements as private equity and hedge funds.

If enacted in its current form, the directive will impose a comprehensive regulatory regime on the managers of all collective investment vehicles that are not qualifying UCITs, whether open- or closed-ended and whether or not listed, subject to certain exclusions. This could significantly increase the costs faced by real estate fund managers in launching, marketing and operating funds.

In an interview for our June 2009 PricewaterhouseCoopers publication [Asset Management News](#), Dan Waters, Sector Leader for Asset Management at the Financial Services Authority (FSA), commented: "this has been understandably driven by enormous political pressure when we are living through what has been dubbed the Great Recession. We consider that changes in regulation are warranted, but we are concerned about the rapid pace of this and the lack of consultation with stakeholders, and we are worried about the unintended consequences of legislation that treats such a wide range of asset management businesses in the same way. Fortunately, the European Parliament elections have intervened and will give us more time to collect feedback about the proposals in the directive. This is a huge priority for us. We need to create the window for meaningful consultation that the EU

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process has not allowed. We are running town hall meetings and will devote our annual conference in September to this important issue. To the extent that the proposed directive diverges from the work that was done by the G20 in this area, it needs to be questioned. Furthermore, the underlying analysis needs to be produced to justify some of the proposals.”

AIFM, which are divisions of EU banks or insurers, authorised pension fund managers and sovereign wealth funds are excluded from the scope of the directive, potentially putting those institutions at a relative competitive advantage and creating an unlevel playing field in the EU asset management industry.

The directive will apply to all AIFM with assets under management in excess of €100m (including any leverage employed). On this point too there is a lack of clarity in the current drafting and it is unclear if this is net or gross assets, but does include assets “acquired through the use of leverage”. This limit is cumulative that applies to the total of all funds managed by the AIFM and is not on a per fund basis. For AIFM that manage unleveraged funds, the threshold is €500m, provided investors are locked in for at least 5 years. Non-EU AIFM who do not manage or market any funds in Europe will be outside the scope of the directive.

All AIFM that are caught by the directive will need to be regulated by their ‘home state’ financial regulator. The authorisation process will require submission of detailed information to the regulator about managers and controllers, about the funds to be managed (strategies and constitution), the countries where the funds are to be sold and details of the custodians, valuers and other third parties to whom material functions are delegated.

All AIFM that become regulated will need to meet the following requirements (among others):

- Regulatory capital of €125,000 plus an amount equal to 0.02% of funds under management;
- Documented internal systems of management and control complying with EU standards (as yet unspecified) relating to liquidity, management of conflicts of interest, risk management (including appropriate ‘documented and regularly updated due diligence when investing’) and short selling;
- An independent ‘valuator’ appointed for each fund, who must value assets in the fund on at least a yearly basis, in accordance with local GAAP or in accordance with rules set out in the fund’s constitution;

- An independent depositary for each fund (which must be an EU authorised credit institution), whose function will be to receive investor subscriptions, safekeep financial assets and to verify the fund has ownership of assets it has invested in;
- An EU or EU-qualified auditor to audit each fund.

All AIFM will be required to disclose to their regulators details (yet to be specified) of the principal markets and investments in which they trade (including, on an aggregated basis, details of their principal exposures and concentrations) and details of their leverage through quarterly reporting. The directive contains unusual provisions specifying that the Commission (rather than a home state regulator) can impose caps on the amount of leverage an AIFM can employ in a fund. The home member state of an AIFM can impose additional limits on leverage, in exceptional circumstances if required to maintain financial system stability.

All AIFM will also be required to produce detailed information for prospective investors and, to the extent they use leverage on a systematic basis, detailed information on that usage on a quarterly basis.

Participations in alternatives funds managed by AIFM, which are authorised, may be sold only to professional investors (as defined in MiFID). Initially, such funds may be marketed to professional investors in the AIFM’s home member state but may, subject to complying with passporting requirements, be sold to professional investors in other member states.

An AIFM whose fund acquires 30% or more of the voting rights in other bodies corporate will be subject to an enhanced disclosure regime, under which they will need to disclose to shareholders and other stakeholders in the company concerned, very detailed information regarding their holdings and plans with regard to their investment. For non-listed companies that accept such funds as investors this will mean disclosure of commercially sensitive information that may not currently be publicly available. There is a carve-out for small and medium-sized enterprises (SME), which means that acquisitions of property special purposes vehicles (SPVs) should escape, as the employee and turnover limits will not typically be breached.<sup>1</sup>

<sup>1</sup> Need to satisfy 2 out of the following tests to be a SME: under 250 employees; turnover less than 50M Euro; balance sheet less than 43M Euro.

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The depositary/custodian obligations under the directive are also causing much concern. While an EU custodian is permitted to delegate its functions to a non-EU subcustodian, the directive provides that the custodian remains fully liable for any loss experienced by the fund as a result of the subcustodian's negligence or fraud, which is a substantial deviation from current industry practice and likely to result in substantially increased custodial costs for funds.

The ability of a non-EU AIFM to market funds that are domiciled outside the EU (e.g. in Jersey, Guernsey or Cayman) will be subject to detailed restrictions, including a requirement for the non-EU AIFM to obtain authorisation from an EU member state, and a requirement that the relevant authorities in the fund's jurisdiction have signed an agreement to share tax information that complies fully with the OECD standards with the jurisdiction into which the fund is to be marketed. This passport will not be available for three years, and prior to this, non-EU domiciled funds may only be marketed into those EU states where they can currently be sold under domestic law. In addition, the EU commission must have determined that:

- the third country in which the non-EU AIFM is established has AIFM-related

prudential regulation and ongoing supervision that is equivalent to the directive's and that it is effectively enforced;

- the third country grants EU AIFM equivalent market access to that granted by the EU;
- various information requirements are met by the non-EU AIFM regarding the regulator in the EU state it will market to; and
- there is a cooperation agreement in place between that regulator and the third country regulator.

A substantial number of Jersey Property Unit Trusts (JPUTs) created over the past few years, which have been marketed in the EU, will fall within this portion of the directive. This may drive their sponsors to consider changing the structure of these funds and/or winding down before the full impact of the directive comes into force for non-EU funds (likely to be 2014).

### Possible impact on the real estate industry

- Currently the real estate fund regulatory regime around Europe is broadly divided between relatively lightly regulated partnership regimes (e.g. the UK) and more heavily

regulated regimes (e.g. in Germany, Luxemburg and France). Investors have a choice as to what is most appropriate for them. The new regime will result in all AIFM being heavily regulated with significant increased costs;

- The directive could accelerate a consolidation in the European fund management industry with the burden of regulation making the cost/benefits of managing smaller funds uneconomic;
- There does not appear to be a level playing field with managers owned by sovereign wealth funds, EU-registered banks, pension funds and insurance companies potentially enjoying a carve-out from the directive, which could give them an advantage over other real estate fund managers.

The EU Commission has already said that it expects the directive to be the subject of intense discussion and negotiation, although there has been very little consultation with industry up until now, which is unusual for a directive with such a significant impact. It is to be hoped that this discussion includes suggestions for considerable simplification and clarification, but this will require considerable input from industry participants.

If political approval on the Commission's proposals is reached by the end of 2009, the directive could come into force in 2011. Given the proposed reach of the directive, potentially affected businesses need to assess the potential impact of the directive immediately (including on any proposed new fund launches), so that they can seek to influence the shape of the final directive and its implementing regulations, and, to the extent necessary, start planning for the changes the directive will require.

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